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March 16, 2001

BY HAND DELIVERY

Mr. Kyle D. Dixon
Legal Advisor, Chairman Michael Powell
Federal Communications Commission
445 12th Street, S.W., Room 5-C450
Washington, D.C. 20554

Re: Inter-Carrier Compensation for ISP-Bound Traffic, CC Docket No. 99-68

Dear Mr. Dixon:

The ILECs are currently trying to shop a myth to the Commission, the myth that the CLECs' variable cost of terminating dial-up ISP-bound traffic is substantially less than that of the ILECs. Specifically, they claim the CLECs' cost is only $.0007/MOU, even though states such as Texas and Illinois have recently determined that the actual variable costs are at least twice that level.[1] Based on this assertion, the ILECs urge the Commission to cap reciprocal compensation rates at $.0007/MOU in any transitional inter-carrier compensation plan for this traffic.

This myth has a history. It started with SBC's claim last year during a California Public Utilities Commission proceeding that the costs of terminating ISP-bound traffic resemble the much lower variable costs of tandem switching rather than end office switching.[2] But the California ALJ that heard SBC's witnesses and arguments ruled that SBC had failed to prove the existence of "lower CLEC switching costs as they relate to reciprocal compensation."[3]

[1] *See* ex parte letter dated October 20, 2000 from Allegiance, Intermedia, Focal, Time Warner Telecom, and XO.

[2] Pacific Bell opening brief in Rulemaking 00-02-005 filed September 18, 2000, at pp. 7-8.

[3] Order Instituting Rulemaking on the Commission's Own Motion into Reciprocal Compensation for Telephone Traffic Transmitted to Internet Services Providers Modems,

Although the ILECs now appear to have abandoned their "tandem cost" theory, they continue to proclaim miraculous CLEC cost economies to this Commission, citing recently negotiated reciprocal compensation rates and the asserted economies of softswitches.[4] Upon examination, these claims also prove to be unfounded, as explained in detail below. The only credible evidence in this record demonstrates that CLECs currently terminate ISP-bound traffic using circuit switches, the same switching technology used by the incumbents.

I. There is no basis for the ILECs' claim that termination of ISP-bound traffic involves only minimal variable costs for CLECs.

As a threshold matter, it is manifest that the ILECs don't believe their own arguments. Current reciprocal compensation rates average four-tenths of a cent per minute ($.004/MOU) according to the ILECs' submissions.[5] That is one-third of a cent per minute ($.0033 /MOU) higher than the costs that the ILECs claim CLECs incur, thereby creating a business opportunity with a profit margin of almost 500%. Since the out-of-region CLECs operated by the ILECs enjoy the same market opportunities as stand-alone CLECs, and benefit from better name recognition and access to capital, why haven't any of the ILEC-affiliated CLECs installed softswitches and successfully pursued such an attractive market? The answer is simple: they know these claims are unfounded.

1. The rates in reciprocal compensation settlements must be considered in context and do not prove the cost of terminating ISP-bound traffic -- Verizon claims in its March 1st ex parte that: "Through their recent contracts, carriers have acknowledged that their costs for Internet traffic are negligible. The costs are undoubtedly lower than their contracted-for rate of .07 cents" (p. 2). Presumably Verizon is referencing its recent agreement with Level 3, as well as Level 3's

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Proposed Decision Of ALJ Pulsifer, Rulemaking 00-02-005, December 7, 2000, at p. 61. This order was filed in this proceeding on November 27, 2000 as an attachment to the ex parte filing of Richard M. Rindler on behalf of Focal Communications Corporation.

[4] Verizon ex parte letter filed March 1, 2001, at p. 2; SBC ex parte letter filed February 14, 2001, at p. 1; and BellSouth ex parte letter filed February 1, 2001, at p. 3.

[5] Id. The ILECs also predicted lower rates of $0.00275/MOU for 2001, and $0.0015/MOU for 2002 in their October 12, 2000 ex parte. Our point is equally true under either scenario.

agreement with SBC.[6] Both the language of those agreements, as well as the circumstances, fail to support Verizon's claim.

The actual reciprocal compensation rate in Level 3's agreement with Verizon falls in the range of $.0012/MOU to $.002/MOU. A ".07 cents" figure never appears in that agreement. As for the SBC-Level 3 settlement, the average rate is $.0018 cents per minute of use, retroactive to Sept. 1, 2000, and declines to an average of $.00101 by June 1, 2002.[7] Thus, the fact that rates in some individual states under the agreement may drop to $.0007 next year proves little.

The specific rates in the settlement agreements must be considered in context. As with almost any negotiated settlement of a dispute, one must assume that each party gave up something in exchange for something else. For example, receipt of terminating compensation is linked to Level 3's deployment of transport facilities to Verizon tandem switches. Further, Level 3 and Verizon agreed that Verizon would pay terminating compensation to Level 3 regardless of any change of law for a period of two years. It is likely that the certainty of receiving payment from Verizon, weighed against the risk of loss of the litigation surrounding this issue, influenced Level 3 to consider a terminating compensation rate less than what it would expect absent a threat of uncertainty. In addition, the Verizon settlement with Level 3 was region-wide, meaning that Level 3 would be paid terminating compensation for ISP-bound traffic even in states, such as Massachusetts and New Jersey, where commissions had ruled that Verizon was not required to compensate Level 3. That fact alone indicates that both Verizon and Level 3 believe that the rates agreed to in their settlement are lower than the true costs Verizon or Level 3 would expect to be paid if ISP-bound traffic were compensable in every state in Verizon's territory. Finally, Level 3 has acknowledged that it does not originate traffic at the present time.[8]

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6 See http://www.level3.com/us/news/newsreleases/0,1345,20010117,00.html.

7 Id. The circumstances surrounding the SBC-ICG agreement in 2000 similarly preclude any inferences about costs. That agreement was accompanied by a companion payment from SBC to ICG consisting of millions of dollars (ICG 10-Q dated August 14, 2000), but SBC and ICG have consistently refused to reveal any details about this side arrangement. Further, shortly after settling the dispute with SBC, ICG filed for bankruptcy protection. If the SBC settlement fully compensated ICG, one might assume that the need to file for bankruptcy would have been forestalled.

8 See ex parte letter dated December 22, 2000 from Karen L. Gulick on behalf of Level 3.

Concerns about reduced rates imposed by regulators on policy grounds rather than on actual costs for traffic above a set traffic exchange threshold–which Level 3 presumably at this time would always exceed – may have also influenced Level 3 to accept a rate unrelated to its actual costs. In short, the rates that Verizon and Level 3 mutually agreed to pay and to receive undoubtedly reflect considerable discounts to account for a variety of factors, including litigation risks.

2. Softswitches are not yet the technology of choice for terminating ISP-bound traffic -- The ILECs also rely on the mere existence of softswitches to support their claim that the current cost of terminating ISP-traffic is minimal for CLECs. The central problem with this claim – a problem that is lethal – is timing. The competitive industry agrees that technological advances are inevitable, and that softswitches, or some analogous technology, will likely someday replace the current generation of circuit switches.

But that day is not here yet. Take the example of Focal Communications. Focal has purchased two softswitches for testing, but as of right now every minute of ISP-bound traffic terminated by Focal has been completed by traditional circuit switches (Nortel DMS 500s), circuit switches that are also used by the ILECs. Even if testing goes well, softswitches will not terminate more than 5% of Focal's total terminating traffic by the end of the year. Time Warner Telecom has begun to deploy softswitches into its network, but given the time necessary to achieve efficient utilization and the amount of traffic currently on circuit switches, its network costs will primarily reflect circuit-switched technology for the foreseeable future. Allegiance Telecom has a single softswitch in its network, and Advanced Telecom Group, Inc. is in the testing phase for its softswitch deployment. As stated previously to the Commission, Pac-West Telecomm, Inc. does not have any softswitches in its network.[9] Similarly, e.spire currently uses only circuit switches to terminate ISP-bound traffic. Thus, the ILECs' claim that the CLECs have abandoned circuit switches for the termination of ISP-bound traffic is pure invention.

There's no mystery why CLECs are being so measured about implementing new switch technologies. ICG provided a cautionary example to the industry just

[9] See ex parte letter dated February 16, 2001 from ALTS and CompTel.

last year when it adopted a new technology for terminating Internet calls that ultimately failed to work as anticipated (ICG Communications 10-Q filed November 20, 2000 at p. 11):

> "The Company experienced network performance problems which caused the Company's network performance to drop below certain service levels agreed upon between the Company and certain Internet remote access services ('IRAS') customers. Based on the Company's inability to quickly resolve these problems, the Company issued credits, in accordance with the provisions of the customer agreements, for approximately $8 million."

3. There is no sound economic foundation at present for attributing the costs of softswitches to CLECs -- The fact that CLEC networks continue to use circuit switches to terminate the vast portion of Internet traffic means that the variable costs of softswitches cannot be attributed to the CLECs as a matter of sound economic analysis. As the Commission noted in its Local Competition Order in 1996, CLEC networks represent state-of-the-art investment decisions.[10] The scarcity of softswitches in current CLEC networks thus demonstrates that softswitches have not yet proven themselves to be cost-effective replacements for circuit switches, and thus cannot be included in any current hypothetical efficient network costing paradigm, such as TELRIC.

4. Under current law, the Commission cannot legally rely upon the costs of hypothetical networks under the '96 Act – While the Commission and CLECs certainly do not agree with the result, the ILECs have successfully challenged the Commission's authority to utilize the costs of a hypothetical network for any local exchange carrier. The ILECs vehemently condemned costing based upon hypothetical networks when they appealed the Commission's TELRIC standard to the Eighth Circuit: " ... the FCC's reasoning in adopting its fantasy-network standard is both irrational on its face and plainly incompatible with the purposes of

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[10] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, First Report and Order, 11 FCC Rcd 15499 (1996), vacated in part, Iowa Utilities Board v. FCC, 120 F.3d 753 (8th Cir. 1997), rev'd in part, aff'd in part, AT&T Corp. v. Iowa Utils. Bd., 119 S. Ct. 721 (1999) at paras. 620, 672.

the 1996 Act."[11] They also argued such a system constituted an unconstitutional taking.[12]

Over CLEC and Commission objections, which the CLECs and the Commission maintain today, the Eighth Circuit agreed with the ILECs:

> "It is clear from the language of the statute that Congress intended the rates to be 'based on the cost . . . *of providing the interconnection or network element*,' id. (emphasis added), not on the cost some imaginary carrier would incur by providing the newest, most efficient, and least cost substitute[.]"[13]

Given that the predominant portion of CLEC ISP-bound minutes continue to be terminated by circuit switches, the ILECs should not now be heard to urge the Commission to impose on the CLECs the costs of a hypothetical network consisting only of softswitches. Surely the Commission can see through this "heads I win, tails you lose" approach to cost methodologies. Furthermore, as the Commission has recognized, if the Commission were to cost out the actual network switching equipment used by the CLECs using actual CLEC switch fill ratios instead of hypothetical optimal ratios, the resulting variable costs would likely be higher than the state determinations under TELRIC.[14]

5. <u>The ILECs' claims concerning the costs of softswitches are utterly unfounded</u> -- Turning to the ILECs' claims concerning the costs of softswitches, their estimates are vastly understated. This is demonstrated in detail by Time

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[11] ILEC initial brief filed July 16, 1999, in <u>Iowa Utilities Board v. FCC</u>, No. 96-3321 (8th Cir.), at p. 32. See also the ILECs' reply brief filed August 31, 1999, at 4: "First, networks are built to last longer than the blink of an eye; they cannot be rebuilt instantaneously every time a marginally more efficient technology or configuration comes along. Second, decisions made in one stage of deployment necessarily limit the options available in later stages; early decisions can lock a carrier into a technology or network design that constrains later choices."

[12] ILEC initial brief, at 54-60.

[13] <u>Iowa Utilities Board v. FCC</u>, 219 F.3d 744, 750 (8th Cir. 2000).

[14] <u>See, e.g.</u>, <u>Third Report and Order</u>, <u>Local Competition</u>. CC Docket No. 96-98, released November 5, 1999, at p. 118, where the Commission recognized that lower switch fill rates increase switching costs for the CLECs.

Warner Telecommunications' recent ex parte filing.[15] Time Warner shows that the ILEC calculations assume CLEC networks use only softswitches, with each softswitch being used at 100% utilization. Obviously, these assumptions are not only incorrect, they are impossible.

6. The states have not accepted the ILEC's claims concerning the cost of terminating ISP-bound traffic -- SBC has vigorously urged its softswitch arguments to both the California and Texas Public Service Commissions, but neither state accepted those claims.[16] Inasmuch as the ILECs have been unable to prevail on these issues in fully litigated proceedings with opportunities for cross-examination by both sides, the ILECs' unsupported paper contentions offered in the present proceedings are plainly not entitled to any weight.

II. Any Commission transition plan should be crafted to preserve fair competition for ISP traffic and to minimize disruptions.

We understand that the Commission is being urged to impose both a cap on the reciprocal compensation rates which states require be paid for the termination of ISP-bound traffic, and a cap on the amount of growth that can be compensated. You are well aware of our opposition to federal rate caps, as well as our legal and policy concerns. Nonetheless, in the event that the Commission considers this approach, we wish to make certain technical points about such a plan.

First, the only basis for imposing a rate cap would be the Commission's belief that its cap better reflects the variable cost of terminating ISP-bound traffic than the rates ordered by the states. Once the Commission had made such a determination (and we repeat our belief that such a determination is unnecessary) it would be patently illogical for the Commission to also adopt further restrictions on the amounts of reciprocal compensation paid for ISP traffic termination by placing a cap on the growth of traffic to be compensated. Any such additional limitation would effectively impose a bill-and-keep system on certain incremental

[15] Ex parte letter dated February 28, 2001 from Don Shepheard, Time Warner Telecom.
[16] Proceeding to Examine Reciprocal Compensation Pursuant to Section 252 of the Federal Telecommunications Act of 1996, TX PUC Docket No 21982, Arbitration Award, at 14-16; see also n. 3 supra.

traffic, even though the Commission has not yet commenced its inquiry concerning this approach to inter-carrier compensation. Stated differently, refusing to allow CLECs to recover a portion of their terminating variable costs from originating carriers (and we repeat that the creation of a Federal rate cap necessarily assumes the Commission understands those costs) would amount to a "stealth" implementation of bill-and-keep prior to any Commission determination concerning the merits of that system for this traffic, or any traffic.

Second, it would also be illogical for the Commission to permit any state to impose or continue a bill-and-keep regime for this traffic at the present time. We fully appreciate that the Commission intends to open a rigorous investigation into whether bill-and-keep might be a preferable regime to reciprocal compensation. But the fact the Commission finds such an investigation necessary prior to taking any action plainly demonstrates there cannot be any sound basis for allowing states to "jump the gun" on this important issue. There simply is no reasoned way the Commission could reconcile its willingness to override the rate level decisions of numerous states, made after lengthy hearings and considerations, with a totally deferential approach to those states that have moved to bill and keep for this single segment of traffic.[17]

Third, we are also concerned that if the Commission were to adopt a new intercarrier compensation rule for ISP-bound traffic under Section 201 of the Communications Act, which we strongly believe it may not and should not,[18] such a decision has the potential to force CLECs back into litigation in the states over exactly what the Commission did and intended to do. The investment community simply will not tolerate such uncertainty. It is imperative that the Commission provide the least disruptive transition to any new federal rule under Section 201, if that is the statutory section the Commission chooses to resolve this dispute.[19]

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[17] If the Commission were to permit states to preserve bill-and-keep regimes for ISP-bound traffic, at a minimum it would have to require that such an approach be immediately extend to all traffic.

[18] Ex parte letter dated November 30, 2000, from Kelley Drye & Warren on behalf of Intermedia, Time Warner Telecom, Focal, KMC, and e.spire.

[19] This matter can and should be decided under Section 251 of the Telecommunications Act, whether or not ISP-bound traffic is jurisdictionally interstate. *See* Comments of RCN Telecom Services, Inc. and Connect Communications Corporation (July 21, 2000).

The Commission should emphasize that the new federal rule changes very little and that all state decisions made prior to issuance of the new federal rule are valid, not inconsistent with the new federal rule, and consistent with conclusions the Commission likely would have reached at the time. To the maximum extent possible, the Commission should affirmatively endorse those prior decisions that require compensation to be paid to CLECs as the reasonable exercise of state commission authority in the absence of a federal rule.

The reason for this need for clarity is that one can expect the ILECs reflexively to interpret any decision made now under Section 201 rather than Section 251 to raise a conflict with the decisions made previously by the states under Sections 251 and 252. The ILECs have already argued before the DC Circuit that the aspect of the ISP Declaratory Ruling[20] that permitted states to arbitrate the issue under Section 252 went beyond the requirements of the Act. This argument was not addressed because the ISP Declaratory Ruling was remanded to the Commission on other grounds. If the Commission rules that Section 201 applies to this traffic, and not Sections 251 and 252, one can expect the ILECs to assert that the Commission has vindicated their argument that state commission decisions on this issue considered under Section 251 and 252 are invalid. More than 37 states have conducted proceedings on this issue, and more than 30 have issued decisions since the ISP Declaratory Ruling following the guidance from the Commission that they had the authority to resolve this issue under Sections 251 and 252. Unless the Commission makes perfectly clear that that approach was eminently reasonable and lawful under existing law, CLECs are faced with time consuming, expensive litigation before state commissions to defend rights they won as much as four years ago. CLECs simply should not be required and cannot bear to allocate resources to this repetitive, senseless re-litigation in almost every jurisdiction in the country, and the ILECs know it.

The Commission should reiterate that there was no federal rule under Section 201 applicable to intercarrier compensation for ISP-bound traffic. The

[20] Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; Inter-Carrier Compensation for ISP-Bound Traffic, 14 FCC Rcd 3689 (1999), vacated, Bell Atlantic v. FCC, 206 F.3d 1 (D.C. Cir. 2000) ("ISP Declaratory Ruling").

Commission must also make clear, as it did in the ISP Declaratory Ruling, that carriers may have agreed to treat this traffic as local under interconnection agreements, and those agreements would be binding on the parties. Any Commission decision must make clear that decisions of state commission going to the intent of the parties remain undisturbed by a new Commission rule on intercarrier compensation. Because the Commission is enunciating the specific Federal policy first announced in the February 1999 decision, nothing has changed to affect the validity of those prior decisions.

The ISP Declaratory Ruling also made clear that state commissions could arbitrate this issue pursuant to their authority under Section 252. According to the ISP Declaratory Ruling, state commission authority under Section 252 applies to interstate as well as intrastate traffic. In the absence of a federal rule, state commissions were obligated to resolve this matter pursuant to their Section 252 authority as best they could, and Commission precedent supported conclusions that reciprocal compensation was owed for this traffic. As the Commission argued in its brief in the D.C. Circuit appeal, the Act permits states to arbitrate issues beyond those enumerated in Section 251 consistent with federal law, and that compensation for ISP-bound traffic fell within this framework. The Commission recognized that although reciprocal compensation for ISP-bound traffic was not mandated by the Act, in its view, it was not precluded by the Act either. According to the Commission, "neither the statute nor our rules prohibit a state commission from concluding in an arbitration that reciprocal compensation is appropriate in certain instances not addressed by section 251(b)(5), so long as there is no conflict with governing law."[21] In the absence of a federal intercarrier compensation rule, there is no conflict with state decisions requiring intercarrier compensation.

The CLEC community urges the Commission not to adopt a rule regarding intercarrier compensation for ISP-bound traffic under Section 201. The potential problems discussed above could be completely avoided by adopting a rule under Section 251(b)(5), which we believe provides the Commission with the proper statutory framework to resolve this issue. In the event that the Commission continues to rely on a Section 201 theory, the Commission must emphasize:

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[21] ISP Declaratory Ruling, para. 26.

-- as first announced in the ISP Declaratory Ruling, in the absence of a prior federal rule, states had the authority to resolve the question based upon the unsettled nature of federal law and the broad grant of arbitration authority under the Act;

-- any new federal rule under Section 201 provides further legal foundation for prior state commission decisions in addition to the previously stated Section 251 and 252 legal foundation;

-- any new federal rule applies only prospectively;

-- state commission decisions issued prior to the new Commission rule did not conflict with governing federal law, and therefore remain undisturbed by a new federal rule.

The competitive telecommunications industry supports the Commission's efforts to complete its examination of inter-carrier compensation for ISP-bound traffic as promptly as possible. Please let us know if we can assist you with this inquiry in any way.

Sincerely,

John D. Windhausen /MWF

John D. Windhausen, Jr.
President, ALTS

H. Russell Frisby /MWF

H. Russell Frisby, Jr.
President, CompTel

cc: G. Reynolds
J. Jackson
T. Preiss
R. McDonald
M. MacBride
J. Goldstein
R. Beynon
D. Shetler
J. Zinman
S. Whitesell